

GAO

**Internal Control
Exposure Draft**

December 1997

**STANDARDS FOR
INTERNAL CONTROL
IN THE FEDERAL
GOVERNMENT**



PREFACE

These standards are provided as guidelines to assist managers in achieving the objectives of their organization. The standards apply equally to program implementation and administration as well as financial operations. They are intended to help both program and financial managers.

The Office of Management and Budget (OMB) Circular A-123, "Management Accountability and Control," June 21, 1995, provides the requirements for assessing controls. These General Accounting Office (GAO) standards provide the measure of quality against which controls in operation are assessed. The discussions on the components of internal control, such as analyzing risks and monitoring controls, are presented as explanations to enhance the understanding of the standards.

OMB Circular A-123 uses the term "management control" to cover all aspects of "internal control" over an agency's operations. The term internal control in this document is synonymous with the term management control in that the broad objectives of internal control (operations, financial, and compliance) cover all aspects of an agency's operations.

Beginning with the Accounting and Auditing Act of 1950, agency heads have been required to establish and maintain effective internal control. Since then, other laws have required renewed focus on internal control. The Federal Managers' Financial Integrity Act of 1982 (FMFIA), requires agency heads periodically to evaluate their systems of internal control using the guidance issued by the OMB and to report on whether their systems conform to the standards issued by the GAO. Most recently, the Federal Financial Management Improvement Act of 1996 (FFMIA), in focusing on financial management systems, identifies internal control as an integral part of those systems.

Over the years, GAO has issued numerous publications to assist agencies in establishing and maintaining effective internal control systems. In 1983, GAO drew on its previously issued guidance and experts throughout government, private sector, and academic communities to develop and issue "Standards for Internal Controls in the Federal Government" to facilitate implementation of FMFIA. Although those standards remain conceptually sound and are used throughout the federal government, this update enhances the standards to recognize recent internal control evaluation guidance developed by the private sector with assistance from GAO and others as well as to give greater recognition to the increasing use of information technology.

The proposed standards supersede GAO's "Standards for Internal Controls in the Federal Government." They incorporate the existing GAO standards and the components of internal control covered in Internal Control--Integrated Framework, by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).¹ The eight major internal control standards contained in this revision follow the COSO guidance closely and also include reference to portions of OMB Circular A-123 that provide guidance for evaluating internal control. Two of the standards concerning management reporting on internal control and resolution of audit findings are standards not addressed by COSO but reflect the public's demand for a high level of accountability for government stewardship of resources. These two standards are currently required by law and by the existing internal control standards. Appendix II provides a crosswalk from the existing standards to those proposed in this document. When issued in final, these standards will replace the existing standards.

To facilitate review of these proposed standards, they are located on the internet on GAO's Home Page (www.gao.gov/). Additional copies of these proposed standards can be obtained from the U.S. General Accounting Office, room 1100, 700 4th Street NW, Washington, DC 20548 or by calling (202) 512-6000. Please send comments by March 11, 1998, to Robert W. Gramling, Director, Corporate Audits and Standards, Accounting and Information Management Division at:

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¹Internal Control--Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission (COSO), September 1992.

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Abbreviations

AIMD	Accounting and Information Management Division
CFO	Chief Financial Officers
COSO	Committee on Sponsoring Organizations of the Treadway Commission
CPA	Certified Public Accountant
FASAB	Federal Accounting Standards Advisory Board
FDIC	Federal Deposit Insurance Corporation
FFMIA	Federal Financial Management Improvement Act of 1996
FMFIA	Federal Managers' Financial Integrity Act of 1982
GAAS	Generally Accepted Auditing Standards
GAO	United States General Accounting Office
GPRA	Government Performance and Results Act of 1993
GSA	General Services Administration
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
OPM	Office of Personnel Management

INTRODUCTION

This document contains the internal control standards for executive agencies, as required by the FMFIA. Internal control is a major part of the management processes of any organization. Internal control comprises the plans, methods, and procedures used by an entity to meet its objectives. Effective internal control is essential to achieving the proper conduct of government business with full accountability for the resources made available. Internal control helps ensure that an agency meets its missions, goals, and objectives; complies with laws and regulations; is able to provide reliable financial and other information concerning its programs, operations, and activities; and serves as the first line of defense to preventing and detecting fraud.² They facilitate achieving management objectives by serving as checks and balances against undesired actions. In preventing negative consequences, internal control helps achieve the positive aims of program managers.

DEFINITION AND OBJECTIVES

Internal control is defined as a process, effected by an agency's management and other personnel, designed to provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations including the use of entities resources.
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use.
- Compliance with applicable laws and regulations.

A necessary implication or subset of these objectives is the safeguarding of agency assets against unauthorized acquisition, use, or disposition. Consequently, the definition of internal control as it relates to safeguarding assets can be expanded to include processes, effected by an agency's management and other personnel, designed to provide reasonable assurance regarding prevention of or prompt detection of unauthorized acquisition, use, or disposition of the agency's assets.

Objectives should be identified at all levels throughout the agency. An agency should first establish its entitywide objectives and then more specific objectives, when determinable, throughout the various levels in the entity. Objectives at different levels should also be

²Fraud is the intentional misrepresentation of financial information or theft of or intentional misappropriation of assets.

linked to activities throughout the organization and should be internally consistent and complementary.

FUNDAMENTAL CONCEPTS

The definition of internal control and the objectives which it seeks to attain reflect several associated fundamental concepts. These concepts are useful in understanding and applying the internal control standards discussed on succeeding pages.

Internal Control Is an Ongoing Process

Internal control is not one event, but a series of actions and activities that permeate an entity's operations. These actions are inherent in the way management runs the entity. Internal control should not be looked upon as separate, specialized systems within an agency. Rather, they should be recognized as an integral part of each system that management uses (for example, the budget development and execution systems) to regulate and guide its operations. In this sense, internal control is management control that is built into the entity and are a part of its infrastructure.

Internal Control Is Effected by People

People are what make internal control work. The responsibility for good internal control rests with all managers; everyone in the organization plays a part in making it happen. People set the objectives, put the control mechanisms and activities in place, and monitor and evaluate the control.

Internal Control Provides Reasonable Assurance, Not Absolute Assurance

No matter how well designed and operated, internal control can not provide absolute assurance that all objectives will be met. Management should design and implement internal control based on the related cost and benefits. Once in place, internal control provides reasonable, not absolute, assurance of meeting objectives because human mistakes and judgmental errors, management's capacity to override control, and acts of collusion to circumvent control can hamper meeting objectives. Nevertheless, in the federal government, internal control effectively designed and operated provides the best available insurance that objectives of the agency will be achieved.

Internal Control Is Geared to Achieving Objectives in One or More Separate but Overlapping Categories

An objective in one category may overlap or support objectives in another category. In addition, the category into which an objective falls can sometimes depend upon the specific circumstances of an event or transaction or the environment of the entity. Some types of objectives are common to all entities, such as producing reliable financial statements and complying with all applicable laws and regulations. Others, particularly those related to operational efficiency and effectiveness, such as processing loan guarantee applications, are entity-specific and directed at the individual mission and goals of the agency.

EVALUATION AND REPORTING REQUIREMENTS

The FMFIA places several responsibilities on agency management for evaluating and reporting on internal control. The act directs the heads of executive agencies to

- annually evaluate their internal control using guidelines established by the OMB and
- annually report on whether agency internal control complies with the standards prescribed by the Comptroller General. Where internal control does not comply, agencies must identify the weaknesses involved and describe the plans for corrections.

ORGANIZATION OF THESE STANDARDS

This document presents eight standards for the development, operation, and evaluation of internal control for federal agencies. The first five of these standards are considered to be components of internal control. They are derived from the way management operates an agency and are integrated with the management process. They are considered essential for effective internal control.

The latter three standards address evaluating and reporting on internal control. In particular, the sixth standard provides a basis for determining whether agency internal control is effective. The seventh cites the requirements of FMFIA for reporting on internal control. The final standard requires the prompt resolution of audit findings and recommendations related to internal control.

Additional sections discuss the internal control roles and responsibilities of various individuals and groups and explain the inherent limitations of internal control.

These standards replace the existing standards when issued in final.

INTERNAL CONTROL STANDARDS

The internal control standards define the minimum level of quality acceptable for internal control in operation and constitute the criteria against which internal control is to be evaluated. These internal control standards apply to all operations; administrative and programmatic functions, but are not intended to limit or interfere with duly granted authority related to developing legislation, rule making, or other discretionary policy making in an agency.

COMPONENT STANDARDS

Control Environment

Management and employees shall establish and maintain a control environment throughout the organization that sets a positive and supportive attitude toward internal control and control consciousness. A positive control environment is the foundation for all other standards of internal control, providing discipline and structure. The control environment is the setting which influences the quality of internal control. Several key factors influence internal control. These factors include the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by top management and oversight groups.

Risk Assessment

Internal control should provide for an assessment of the risks the agency faces from both external and internal sources. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks associated with achieving the objectives of the agency (for example, those program objectives and financial limitations set forth in the budget) and forming a basis for determining how risks should be managed. Because governmental, economic, industry, regulatory, and operating conditions continually change, mechanisms should be provided to identify and deal with any special risks associated with change.

Control Activities

Internal control activities are to be effective and efficient in accomplishing the agency's control objectives. Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives, such as, the process of adhering to Management orders for budget development and execution. They help ensure that actions are taken to address risks. Control activities occur at all levels and in all functions of the entity. They include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, segregation of duties, and the creation and maintenance of related records (such as documentation) which provide evidence of execution of these activities as well as appropriate audit trails.

Information and Communications

For an entity to run and control its operations, it must have relevant, reliable information, both financial and nonfinancial, relating to external as well as internal events. That information must be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities.

Monitoring

Internal control must be monitored. Monitoring is a process that assesses the quality of performance over time. This is to be accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations shall depend primarily on the assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be communicated to the individual responsible for the deficient function and also to at least one level of management above that individual. Serious matters should be reported to top management.

EVALUATION AND REPORTING STANDARDS

Effectiveness of Internal Control

For internal control to be judged effective, management must have reasonable assurance that

- **the agency's operational objectives are being met,**

- **the published financial statements and reports prepared for internal and external use (such as budget execution reports) are reliably prepared, and**
- **compliance with applicable laws and regulations is being achieved.**

The significance of all internal control deficiencies identified by management, employees, Inspectors General and other auditors, or other sources must be evaluated individually and collectively by management in deciding their effect on the five components of internal control and the related impact on whether the objectives of internal control are being met. OMB Circular A-123, "Management Accountability and Control," dated June 21, 1995, provides guidance on assessing internal control deficiencies. Financial statement auditing standards provide additional guidance in assessing financial reporting weaknesses.

Reporting to External Parties

Management shall provide an annual public report presenting its assertion about the effectiveness of its internal control. The FMFIA requires that the heads of executive agencies report annually to the President³ on internal control, identifying any material weaknesses and plans for correcting them. It also requires that agencies make these reports available to the public. OMB Circular A-123, provides guidance on how to satisfy FMFIA's reporting requirement.

Audit Resolution

Audit findings shall be promptly resolved. Managers are to (1) promptly evaluate findings, those showing deficiencies and others, and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

³The Federal Reports Elimination and Sunset Act of 1995 eliminates, effective 1999, the requirement to report to the Congress.

DETAILED EXPLANATION OF STANDARDS

The internal control standards define the minimum level of quality acceptable for internal control in operation and constitute the criteria against which internal control is to be evaluated. These internal control standards apply to all operations; administrative and programmatic functions, but are not intended to limit or interfere with duly granted authority related to development of legislation, rule-making, or other discretionary policy-making in an agency.

The eight internal control standards can be categorized into two groups.⁴ One group comprises the five standards that relate directly to the functioning and operation of the internal control. The second group contains the other three standards which deal with evaluating the internal control, reporting on them, and responding to audit findings and recommendations.

COMPONENT STANDARDS

Internal control consists of five interrelated components which form an integrated process that can react to changing circumstances and conditions within the entity. These components are derived from the way in which agencies conduct their activities and are integrated within the management processes. The components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. Each of these components is essential to achieving the operations, financial reporting, and compliance objectives of internal control. The standards for each are discussed below.

⁴To a large degree, these standards parallel and draw upon the criteria presented in Internal Control--Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in September 1992. COSO consists of the American Institute of Certified Public Accountants, the American Accounting Association, The Institute of Internal Auditors, the Institute of Management Accountants, and the Financial Executives Institute. Copies of Internal Control - Integrated Framework may be obtained from the Order Department, American Institute of Certified Public Accountants, HaborSide Financial Center, 201 Plaza III, Jersey City, NJ 07311-3881.

Control Environment

Management and employees shall establish and maintain a control environment throughout the organization that sets a positive and supportive attitude toward internal control and control consciousness.

A positive and supportive control environment, providing discipline and structure, is the foundation for all other standards of internal control. The control environment is influenced by the agency's history and culture and it, in turn, influences how the agency conducts its activities. This standard requires that agency managers and other personnel be attentive to internal control and take it seriously. Attitude affects the quality of internal control and, as a result, the quality of performance and the achievement of internal control objectives. Attitude is not reflected in any one particular aspect of management's actions, but rather is fostered by management's commitment to achieving strong control through all of its actions that contribute to a positive control environment.

There are seven major factors that significantly affect the entity's control environment. These factors are (1) the integrity and ethical values of management and employees of the agency, (2) the competence of its personnel, (3) management's philosophy and operating style, (4) the way the agency is organized, (5) the manner in which management assigns authority and responsibility, (6) how the agency develops and trains its human resources, and (7) the attention and direction provided by oversight groups. They are discussed below.

1. Integrity and Ethical Values

An agency's top-level management plays a key role in providing leadership and in establishing and maintaining the organization's ethical tone. It has primary responsibility for communicating behavioral standards to the rest of the agency. Management and its staffs must maintain and demonstrate personal and professional integrity and the prevention of fraud. Integrity is a prerequisite for ethical behavior in all aspects of an agency's activities. Management should (1) remove or reduce incentives or temptations for unethical behavior, (2) provide--through a formal code of conduct as well as by example--explicit guidance on what is proper and what is inappropriate behavior, and (3) discipline violators.

2. Commitment to Competence

Managers and employees should possess and maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal control. Management needs to specify the competence level for particular jobs and translate those levels into requisite knowledge and skills. Management should provide appropriate training and experience for specific jobs. In addition, counseling and performance appraisals are important. Performance

appraisals should be based on an assessment of critical factors, including the implementation and maintenance of effective internal control.

3. Management's Philosophy and Operating Style

The nature of internal control can be affected by the degree to which management is willing to accept risks and the degree of economic or regulatory control imposed by others. Other elements affecting the entity's philosophy and style include attitudes toward reporting (both financial and programmatic) and the use of aggressive or conservative accounting principles and estimates and other rules for reporting. In addition, the attitude of management toward data processing and accounting functions and personnel in general can have a profound effect on internal control. One important way for management to demonstrate its support for good internal control is to emphasize the value of an Inspector General, external audits, and other evaluations and studies, and its responsiveness to information developed through such products.

4. Organizational Structure

The organization of an agency provides its management with the overall framework for planning, directing, and controlling its operations to achieve its objectives. Good internal control requires that the entity's organizational structure clearly define key areas of authority and responsibility and establish appropriate lines of reporting. The appropriateness of the structure depends, in part, upon the entity's size and the nature of its activities. However, the organization of activities should be designed to achieve the entity's overall objectives.

5. Assignment of Authority and Responsibility

For an agency to accomplish its mission, management must delegate authority and responsibility throughout the organization. This delegation covers authority and responsibility for operating activities, reporting relationships, and authorization protocols. A critical internal control challenge is to delegate enough to achieve the objectives, but not so much that internal control is significantly weakened. Another challenge is ensuring that each individual knows how his or her actions interrelate and contribute to meeting the objectives. With increased delegation of authority and responsibility, management should have effective procedures to monitor results. Individuals should be held accountable for their decisions and actions.

Implicit in the assignment of authority and responsibility is the requirement to provide qualified and continuous supervision. Supervision throughout the agency helps ensure that employees are aware of their duties and responsibilities, and know the extent to which they are accountable for agency activities.

6. Human Resource Policies and Practices

This factor ties closely with the ones on commitment to competence and the assignment of authority and responsibility. The agency must establish appropriate practices for hiring, orienting, training, supervising, evaluating, counseling, promoting compensating, and disciplining its personnel. For example, related to hiring, the agency should have standards for hiring qualified people, with emphasis on education, experience, accomplishments, and ethical behavior. Also, training must be an ongoing process and rotation of personnel and promotions should be based on periodic performance appraisals.

The appropriate degree of supervision, review, and approval of assigned work clearly identifies duties and responsibilities and helps to ensure the proper processing of transactions and events, reduces misunderstandings and improper practices, discourages wrongful acts, and provides staff with guidance and training. Bonus and/or award incentives can also be used to reinforce motivation and performance. In addition, disciplinary actions, when deserved, send a message to the rest of the agency that certain behavior will not be tolerated.

7. Oversight Groups

Oversight bodies in the federal government are the Congress and central agencies (OMB, Treasury, General Services Administration (GSA), the Office of Personnel Management (OPM), and GAO). In its oversight role, the Congress mandates the programs that agencies are to undertake and the extent and depth of the undertaking. GAO supports the Congress in its role. The central agencies provide policy and other guidance to agencies. The Congress also monitors the agencies' progress toward meeting the mandated goals.

Within agencies, there are also mechanisms in place to monitor operations and programs. These include senior management councils.⁵ Such councils may include high-level line and staff management as well as the agency inspector general. Agencies may also have audit committees analogous to the private sector. Senior management councils may help to fill the role of an audit committee and thereby, improve the agency's internal control.

Risk Assessment

⁵OMB Circular No. A-123; Revised; "Management Accountability and Control"; June 21, 1995; Attachment, Section III, Assessing and Improving Management Controls, discusses the role of an agency senior management council. It states that many agencies have found such a council to be a useful forum for assessing and monitoring deficiencies in management control.

Internal control should provide for an assessment of the risks the agency faces from both external and internal sources.

Every agency faces risks that could threaten the achievement of its objectives. These risks come from a variety of external and internal sources. Risk assessment is the identification and analysis of possible risks in meeting the agency's objectives and forming a basis for how these risks should be managed or controlled and the deterrents that should be implemented.

A precondition to risk assessment is the establishment of objectives, linked at different levels and internally consistent. By setting objectives at both the entity and activity levels in terms of operations, financial reporting, and compliance with laws and regulations, agencies can identify critical success factors. These are the things that must occur or "go right" if the objectives are to be met. Knowing what must go right is critical to identifying the risks of what can go wrong.

The identification and analysis of risk is a continual process that is critical to the effectiveness of internal control. Management must focus on risks at all levels in the entity and act to manage them.

1. Risk Identification

Management should be comprehensive in its identification of risks and should consider all significant interactions between the entity and other parties as well as internal factors at both the entity-wide and activity level. Many methods of risk identification may be used, including

- qualitative or quantitative methods to identify and rank high-risk activities,
- senior management planning conferences, and
- short and long-range forecasting and strategic planning.

Management should carefully consider the specific external factors that may present risk to the agency. Examples of such external factors that could cause risk include the following:

- technological developments;
- changing needs or expectations of the Congress, agency officials, and the public;
- new legislation and/or regulations;
- natural catastrophes; and
- business, political, and economic changes.

Examples of internal factors that can give rise to risk may include the following:

- downsizing agency operations,
- reengineering agency operating processes,
- disruption of information systems processing,
- highly decentralized program operations,
- the quality of personnel hired and training provided,
- heavy reliance on contractors or other related parties to perform critical agency functions,
- changes in management responsibilities, and
- the nature of the entity's activities and employee access to assets.

In identifying risks, management must also consider other factors that may contribute to or increase the risk to which the agency may be exposed. Examples of such considerations include past failures in meeting budget limits and agency objectives and the reasons for those failures; making improper program expenditures; geographically distributed agency activities; and the significance and complexity of any specific activity which the agency undertakes.

2. Risk Analysis

The risk analysis methodology can vary because levels of risk are difficult to quantify. However, the processes of analysis would generally include the following:

- estimating the risk significance,
- assessing frequency/likelihood of occurrence, and
- considering how to manage the risk and the actions to be taken.

All of these must be considered together. A risk that has little significance and low probability of occurring may require no action at all. Yet, one with high significance and high frequency will usually require much attention. Once risks have been analyzed, management needs to formulate an approach for risk management and control based upon how much risk can be prudently accepted. The approach can vary considerably from one agency to another, but all approaches should be designed to keep risks within the levels judged appropriate by management. Once the approach has been implemented, it should be monitored and tracked for effectiveness.

3. Managing Risk During Change

Because governmental, economic, industry, regulatory, operating, and other conditions continually change, mechanisms should be provided to identify and deal with any special risks associated with change. Changing conditions often can greatly increase risks to an agency. Mechanisms should be in place to help management identify such changes. These mechanisms need not be elaborate, but are usually related to the recording and use of information.

Some major changing conditions that warrant special consideration with regard to risk may include the following:

- new personnel in key positions or high personnel turnover;
- new or changed information systems;
- rapid growth, expansion, or downsizing;
- implementation of major new technologies;
- production or provision of new outputs; and
- starting operations in new geographical areas.

Control Activities

Internal control activities are to be effective and efficient in accomplishing the agency's control objectives.

Control activities are the policies, procedures, techniques, and mechanisms that ensure that management's directives are being carried out to meet the agency's objectives, including, for example, budget, program, and financial objectives and to prevent and detect fraud. They help ensure that necessary actions are taken to address risks affecting those objectives. They can usually be categorized by the specific objective (operational, financial reporting, or compliance) to which they relate, but often a particular control activity may apply to the achievement of more than one objective. Control activities occur at all levels and in all functions of the entity. They include a wide range of diverse mechanisms and activities such as organizational plans, managerial approvals and authorizations, verifications, reconciliations, performance reviews, maintenance of security, restrictions on access to resources, segregation of duties, and documentation of transactions and events and of the internal control structure itself.

Internal control activities involve two elements: policy on what should be done and procedures, techniques, and mechanisms to effect the policy. Policies should be in writing and should be implemented thoughtfully, conscientiously, and consistently. The procedures, techniques, and mechanisms to implement policy should continually provide a high degree of assurance that the internal control objectives are being achieved. To do so they must be effective and efficient. To be effective, control procedures, techniques, and mechanisms should fulfill their intended purpose in actual application. They should provide the coverage they are supposed to provide and operate when and as intended. They should be designed to derive maximum benefit with minimum effort to achieve efficiency. In addition they should be regularly monitored and evaluated.

1. Types of Control Activities

Many different types of control activities have been described including preventive control, detective control, manual control, computer control, and management control. Control activities, however, can also be classified by specific control objectives, such as ensuring completeness and accuracy of information processing. The following are certain categories of control activities that should be common to all agencies and examples that should be established for each. These are presented to illustrate the range and variety of control activities and are not all-inclusive of the control activities that a particular agency may require.

A. Top Level Reviews

Management should regularly review actual performance versus budgets, forecasts, and prior periods results. The Government Performance and Results Act of 1993 (GPRA) requires that agencies develop strategic plans that cover a period of at least 5 years, annual performance plans, and report on the achievement of goals and objectives on an annual basis. (These performance reports start in March 2000.) GPRA requires that agencies develop performance targets and measures and report results. Top level management should be involved in these processes. Major agency initiatives should be tracked for target achievement. Implementation of plans should be monitored. Management actions taken to analyze and follow up on such tracking and monitoring represent control activities as well as the agency's control environment.

B. Direct Functional or Activity Management

The agency's managers also review performance reports, analyze trends, and relate results to targets. Financial and program managers should review reports designed to compare performance to planned or expected results. Other control activities may include reconciliations of summary information to supporting detail (e.g., control accounts to subsidiary accounts) and checking summarizations of operations.

C. Information Processing

A variety of control activities may be used to check data accuracy, completeness, and the appropriate authorization of transactions. Data entered into systems should be subjected to edit checks and matched to approved control files. Transactions should be accounted for in numerical sequences. File totals should be compared with control accounts. Exceptions should be examined and acted upon. Access to information processing data, files, and programs must be controlled.

D. Physical Control

Various types of assets such as equipment, inventories, securities, cash, and any other assets which may be vulnerable to risk of loss or unauthorized use should be physically secured and periodically counted and compared to amounts shown on control records.

E. Performance Indicators

Control activities should be established to monitor performance indicators. This control could call for comparisons and assessments relating different sets of data to one another so that analyses of the relationships can be made and corrective actions, if necessary, can be taken. Investigation of unexpected results or unusual trends enables identification of

circumstances where achievement of activity objectives is threatened. Analysis of performance indicators may serve operational and/or financial reporting control purposes.

F. Segregation of Duties

Key duties and responsibilities should be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling the related assets. To reduce the risk of error, waste, or fraud or to reduce the risk of their going undetected, no one individual should control all key aspects of a transaction or event. Duties and responsibilities should be assigned systematically to a number of individuals to ensure effective checks and balances. Collusion, however, can reduce or destroy the effectiveness of this internal control activity, and management should reduce the opportunities for and watch for collusion.

G. Execution of Transactions and Events

Transactions and other significant events should be authorized and executed only by persons acting within the scope of their authority. These authorization control activities deal with management's decisions to exchange, transfer, use, or commit resources for specified purposes under specific conditions. It is the principal means of assuring that only valid transactions and other events are initiated or entered into. Authorization should be clearly communicated to managers and employees and should include the specific conditions and terms under which authorizations are to be made. Conforming to the terms of an authorization means that employees are carrying out their assigned duties in accordance with directives and within the limitations established by law, regulation, and management.

H. Recording Transactions and Events

Transactions and other significant events should be promptly recorded and properly classified. Transactions must be promptly recorded if pertinent information is to maintain its relevance and value to management in controlling operations and making decisions. This applies to (1) the entire process or life cycle of a transaction or event and includes the initiation and authorization, (2) all aspects of the transaction while in process, and (3) its final classification in summary records. Proper classification of information on transactions and events refers to the organization and format of information on summary records from which reports and statements are prepared.

I. Access Restrictions to and Accountability for Resources and Records

Access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained. Periodic

comparison of resources with the recorded accountability should be made. The frequency of the comparison should be a function of the vulnerability of the asset. The basic concept behind restricting access to resources and records is to help reduce the risk of errors, fraud, misuse, or unauthorized alteration, and to help achieve the directives of management. However, restricting access depends upon the vulnerability of the resources or records and the perceived risk, both of which should be periodically assessed. Other factors affecting access to assets include the asset value, portability, and exchangeability. Assigning and maintaining accountability for resources and records involves telling specific individuals within the agency that they are responsible for their custody and use.

J. Documentation

Internal control and all transactions and other significant events should be clearly documented, and the documentation should be readily available for examination. The documentation of internal control should include identification of the agency's activity-level functions and related objectives and control activities, and should appear in management directives, administrative policy, and accounting manuals. Documentation of transactions or other significant events should be complete and accurate and should facilitate tracing the transaction or event and related information from before it occurs, through its processing, to after it is completed. The documentation, whether in paper or electronic form, should be purposeful and useful to managers in controlling their operations, and to auditors or others involved in analyzing operations.

2. Integration with Risk Assessment

Along with assessing risks, management needs to act to address those risks. The actions management decides to take to address risks also serve to focus attention on control activities put in place to ensure that the actions are carried out properly and promptly. Control activities are a major part of the process by which an agency achieves its objectives as opposed to being implemented for their own sake or because "it is the right thing to do." In this sense, control is built directly into the management process.

3. Control Over Information Systems

Most information systems today are computerized. Special control applies to them. However, even if the controls are different from those used in manual systems, they are still based on the same underlying concepts.

There are two broad groupings of information systems control--general control and application control. General control applies to all information systems--mainframe, minicomputer, and end-user environments. They also include those manual measures and procedures to help ensure the systems' continued proper operation. Application control

is designed to control the processing of transactions within the application software and include related manual procedures.

A. General Control⁶

These include control over data center operations, system software acquisition and maintenance, access security, and application system development and maintenance. Examples of control activities that agencies should use are described below.

- **Data Center Operations Control** - This kind of control includes job set up and scheduling, operations activities, backup and recovery procedures, and contingency and disaster planning.
- **System Software Control** - These include control over the acquisition, implementation, and maintenance of all system software including the operating system, data based management systems, telecommunications, security software, and utility programs.
- **Access Security Control** - This kind of control protects the systems and network from inappropriate access and unauthorized use by hackers and other trespassers or inappropriate use by agency personnel. Specific control activities include frequent changes of dial-up numbers; use of dial-back access; restrictions on users to allow access only to systems functions that they need; "firewalls" (software and hardware) to restrict access to assets, computers, and net works by external persons; and frequent changes of passwords, deactivation of former employees passwords, and other techniques.
- **Application System Development and Maintenance Control** - This kind of control provides the structure for developing new systems and modifying existing systems. Included are documentation requirements; authorizations for undertaking projects; and reviews, testing, and approvals of development and modification activities before placing systems into operation. An alternative to in-house development is the procurement of commercial software, but control is necessary to ensure that selected software meets the user's needs, and that it is properly placed into operation.

⁶GAO's Federal Information System Controls Audit Manual (GAO/AIMD.12.19.6) addresses these general controls in the following categories: Entity-Wide Security Program, Access Control, Service Continuity, Application Software Development and Change Control, System Software, and Segregation of Duties.

B. Application Control

This kind of control is designed to help ensure completeness, accuracy, authorization, and validity of all transactions during application processing. Control should also be installed at an application's interfaces with other systems to ensure that all inputs are received and are valid and outputs are correct and properly distributed. An example is computerized edit checks built into the system to review the format, existence, and reasonableness of data.

C. Relationship Between General and Application Control

General and application control over computer systems are interrelated. If the general control is inadequate, the application control is unlikely to function properly and could be overridden. The application control assumes that the general control will function properly and provide immediate feedback on errors, mismatches, incorrect format of data, and inappropriate data access (by unauthorized persons). Therefore, general control supports the functioning of application control, and both are needed to ensure complete and accurate information processing.

D. Evolving Information Technology

The field of computer information processing is one of rapid technological change. Changes in technology will change the specific control activities that may be employed and how they are implemented, but the basic requirements of control will not have changed. As more powerful computers place more responsibility for data processing in the hands of the end users, the necessary controls (for example, routines within computer programs that validate data or persons/vendors and the procedures performed by users to ensure accurate processing by the computer) should be identified and selected.

4. Entity-Specific Control Activities

Agencies' internal control activities will be required to follow guidance set by oversight bodies. However, within the requirements, flexibility exists to allow agencies to tailor internal control to fit their needs. The specific internal control activities used by a given agency will be different from those used by other agencies due to a number of factors. These could include differences in objectives; managerial judgment; size and complexity of the organization; operational environment (including such items as exposure to certain risks and location and geographical dispersion); sensitivity and value of data; and requirements for system reliability, availability, and performance. All of these factors should be considered when designing the specific control activities needed for an agency to achieve its objectives.

Information and Communications

For an entity to run and control its operations, it must have relevant, reliable information, both financial and nonfinancial, relating to external as well as internal events. That information must be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities.

Pertinent information must be identified, captured, and communicated in a form and time frame that permits people to perform their duties efficiently. Information systems produce reports containing the information that makes it possible to run and control the agency. Effective communication of information must also occur in a broad sense with relevant information flowing down, across, and up the organization. Management must clearly communicate to all employees that control responsibilities are to be taken seriously. Employees must understand their role in internal control and they must have a means of communicating important information up the chain of command. Communications must also occur with outside parties such as the Congress, other federal agencies, state and local governments, grant recipients and contractors (suppliers), the public, and the media.

1. Information

Information is needed throughout the agency to achieve all of the categories of objectives—operations, financial reporting, and compliance. A given piece of information may help to achieve only one category of objectives or it may be useful in achieving all of them. Information is identified, captured, processed, and reported via information systems, which may be computerized, manual, or a combination of both. Information systems may gather data in a monitoring mode, i.e., routinely capturing specific data as transactions and events occur. The system may also be designed to recover, capture, or develop special data on a one time or occasional basis to suit the special needs of management. Information systems must be flexible and able to be changed quickly to meet the changing needs of management in a dynamic operating and reporting environment.

Information systems are now increasingly becoming a part of the method by which strategic initiatives are implemented by agencies. Improved technology in information capture and analysis has helped many entities respond more rapidly and efficiently to those they serve. In this way, strategic information systems are used to proactively support operational strategies. Such systems help control all the entity's activities, track and record transactions and events as they occur, and maintain and report financial and other data related to operations and/or compliance objectives.

The quality of the information captured, maintained, and reported by the systems will affect management's ability to control the agency and meet the agency's objectives. The

quality of information is measured by such factors as whether the information content is appropriate, timely, current, accurate, and accessible. These quality factors are affected by internal control and must be inherent in the information to help ensure that informed decisions are made throughout the agency.

2. Communications

Information systems inherently imply communications. Information not only must be captured, but it must be provided to appropriate personnel promptly so that they can perform their operating, financial reporting, and compliance responsibilities. Information must be communicated both internally and externally to other appropriate groups.

A. Internal Communications

Communications within the agency is extremely important for good internal control. To ensure that effective internal communications can occur, the following kinds of control should be in place.

- All personnel need a clear message from top management that internal control responsibilities are important and must be taken seriously.
- Specific duties must be made clear to each individual, and each person needs to understand the relevant aspects of internal control and how its role fits into it. Employees should also know how his or her work relates to the work of others. This will help in recognizing problems, determining causes, and taking corrective action.
- Employees should know that when the unexpected occurs in performing their duties, attention must be given not only to the event, but to the cause as well, so that any potential control weaknesses can be identified and fixed. For example, changes in internal operating policies may need to be reviewed and approved by appropriate levels of management within the organization. When evidence of approvals are not available, corrective action should take place prior to implementation.
- All personnel should know what behavior is acceptable and unacceptable. An example of unacceptable behavior can occur when a manager, under pressure to meet deadlines and budgets, unwittingly sends the wrong message by telling subordinates "...to meet the deadline and budget anyway you can..."
- Personnel should have a means of communicating information upstream within the agency. There must be open channels of communication and a clear-cut willingness to listen on the part of management, especially since potential problems can be minimized or even averted by listening to staff concerns.

- In some instances, informal or separate lines of communications are needed to serve as a "fail-safe" control mechanism for normal communications methods.
- Personnel need to know there will be no reprisals for reporting information.
- Agency management must keep internal oversight groups, such as senior management councils, updated on performance, developments, risks, major initiatives, and any other significant or relevant events.

B. External Communications

The agency must communicate with many external groups that can have a very serious impact on programs, projects, operations, and other activities including budgeting and financing. To help ensure that effective external communications exist, the following types of control should be established.

- Communications channels must be established and kept open to customers and others that the agency serves as well as with contractors/suppliers. These groups can provide significant input on quality and design of agency outputs.
- Anyone dealing with the agency must be made to understand that improper actions, such as improper billings or kickbacks and other improper payments will not be tolerated.
- Communication from external parties (other federal agencies, state and local governments, contractors/suppliers, and other related third parties) should be encouraged as it can provide information on the functioning of internal control. Complaints or other inquiries (for example, those concerning services provided such as shipments, receipts, billings, or other activities) should be welcomed as they can point out control problems. They should be reviewed by personnel independent of the original transactions.
- Management must make certain that the advice and recommendations of Inspectors General and external auditors are fully considered.
- Communications to the Congress, state and local governments, contractors/suppliers, the public, the media, and other external parties should provide information relevant to their needs so that they can understand the circumstances and risks facing the agency, and thus better understand the agency.

3. Means of Communicating

Communication may take many forms including policy and procedures manuals, management directives, memoranda, bulletin board notices, videotaped messages, e-mail (as well as other electronic means of conveyance), speeches, etc. However, one of the most powerful forms of communication is the action management takes in dealing with agency personnel throughout the organization and in the support it demonstrates to them.

Monitoring

Internal control must be monitored. Monitoring is a process that assesses the quality of performance over time.

Since conditions change over time, management needs to determine if the internal control continues to be relevant and continues to address new or changed risks. This is done by ongoing monitoring activities, separate evaluations, or a combination of both. Ongoing monitoring occurs during normal operations. It includes regular management and supervisory activities as well as other certain actions personnel take in performing their duties. The scope and the frequency of separate evaluations depends mainly on management's assessment of risks and the effectiveness of the ongoing monitoring procedures. Internal control deficiencies should be reported up the chain of command, with serious matters reported to top-level agency management and externally in accordance with FMFIA requirements.

1. Ongoing Monitoring Activities

Internal control should be designed to monitor itself. The greater the degree and the more effective the ongoing monitoring is, the less need for separate evaluations. Ongoing monitoring activities are performed continually and are ingrained in the agency's operations. Therefore, they are usually more effective than separate evaluations. Activities which serve to monitor internal control in the ordinary course of operations are many and may vary from one agency to another. However, they usually include regular management and supervisory activities, comparisons, reconciliations, and other routine activities. Examples of ongoing monitoring activities which agencies should incorporate into their internal control follow.

- In the process of carrying out regular management functions, management should obtain information as to whether internal control is working properly. Operating reports should be integrated or reconciled with financial reporting system data and used to manage operations on an ongoing basis. Significant inaccuracies or exceptions should alert management to any internal control problems.

- Communications from external parties should corroborate internally generated data. If not, it could indicate problems with internal control. For example, customers paying their invoices help to corroborate billing data, while customer complaints indicate that deficiencies may exist. Similar situations may exist with other external groups.
- Appropriate organizational structure and supervision should provide oversight of internal control functions. For example, automated edits and checks as well as clerical activities help control accuracy and completeness of transaction processing. Separation of duties and responsibilities help to deter fraud.
- Data recorded by information systems should be compared with physical assets and any deficiencies examined.
- Inspectors General and external auditors regularly provide recommendations on improvements in the internal control structure. Management should take appropriate actions.
- Training seminars, planning sessions, and other meetings should provide management with feedback on whether internal control is effective.
- Employees regularly should be asked to state explicitly whether they understand and comply with the agency's code of conduct or similar agency pronouncements of expected employee conduct.

2. Separate Evaluations

While monitoring by ongoing activities provides important feedback on the internal control, separate evaluations of control can be useful by focusing directly on the controls' effectiveness at a specific time. Separate evaluations of internal control may vary in scope and frequency. The frequency and scope of such evaluations necessary for management to have reasonable assurance about the effectiveness of the internal control is a matter of judgment dependent upon the significance of risks being controlled and the importance of control in reducing those risks.⁷ Evaluation of all control is usually needed

⁷The Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(d)) states that heads of executive agencies are to make an annual evaluation of their internal control using guidelines established by OMB. Those guidelines, OMB Circular A-123, Revised; "Management Accountability and Control" states that "Agency managers should continually monitor and improve the effectiveness of management control associated with their programs. This continual monitoring, and other periodic evaluations, should provide the basis for the agency head's annual assessment of and report on management control, as required by the Integrity Act."

less often than for specific parts of the structure. However, control evaluation may be prompted by such things as changes in major management plans or strategies, major expansion or downsizing of the agency, or significant changes in operations or processing of financial data.

Separate evaluations often take the form of self-assessments. In such cases, individuals responsible for a particular unit or function should determine the effectiveness of control for their own activities. Inspectors General may perform the evaluation as a part of their regular duties. External auditors may also be used, or a combination of methods may be employed.

Evaluating the internal control is a process. Specific approaches or techniques may vary by agency, but discipline must be brought to the process and there are certain basics inherent in it. The people performing the evaluation must understand each of the agency's activities and each of the components of the internal control being addressed. Evaluators must determine how the control actually works and compare that to the way it was intended to work. They must be alert to procedures that have become modified over time or may no longer be performed. The evaluator must analyze internal control, test them, and assess the results of tests performed against the backdrop of established criteria. The ultimate goal is to determine whether the control provides reasonable assurance with respect to the stated objectives.

There are many types of evaluation methodologies and tools available. Some of these include checklists, questionnaires, flowcharting methods, quantitative techniques and lists of control objectives, and direct testing of control effectiveness. The evaluator should use those most appropriate to the circumstances encountered and the purposes of the evaluation. Benchmarking against other agencies, nongovernmental entities, or trade or association standards may also be used. Management consultants and auditors may also be helpful.

Internal control should be documented. The evaluator may find, however, that some informal and undocumented internal control activities have been developed and implemented. This control may be tested by the evaluator and may prove to be effective. Nevertheless, an appropriate level of documentation usually makes the evaluation more efficient and helps employees understand how the structure works and their part in it. Therefore, the evaluator may wish to extend the documentation during the evaluation process and recommend that management document control in a formal manner. Appropriate documentation may be needed if assertions are to be made to additional parties about control or the evaluation.

3. Internal Reporting of Deficiencies

Deficiencies in the agency's internal control can show up via the ongoing monitoring activities, as a result of a separate evaluation or via external parties. A "deficiency" is a

condition within the internal control worthy of attention. A deficiency may represent a perceived, potential, or real problem, or an opportunity to strengthen the agency's internal control.

Obviously, when deficiencies are found, they need to be reported. Exactly which problems warrant reporting is highly subjective, but some guidelines can be drawn. All internal control deficiencies that can affect the agency's attainment of its objectives should be reported up the chain of command to those who can take necessary action. In considering what needs to be communicated, it is necessary to look at the implications of the findings. What seems to be a simple problem with an apparently simple solution might have more far-reaching control implications. This underscores the need for reporting deficiencies or other problems up the chain of command. It is essential not only that the deficiency be reported, but that potentially faulty control be reevaluated and fixed.

Providing information to the correct person up the chain of command is critical to the effectiveness of the internal control. It is essential that deficiencies be reported to an official who is in a position to ensure that appropriate remedial actions are implemented. A general rule is that a manager should receive control information needed to affect action or behavior of people under his or her responsibility or to achieve the activity's objectives. However, some critical weaknesses have implications that transcend organizational divisions and these must be resolved at an agencywide level. Regardless of their organizational placement within an agency, the responsible official would need supporting information on the nature of matters that could have significant financial consequences or strategic implications, or that could affect the agency's reputation. The head of the agency should be informed of any serious deficiencies, errors, problems, or infractions of policies and procedures. Senior managers should be apprised of control deficiencies affecting their units, and lower-level managers should be informed of control deficiencies in their units in increasing levels of detail as one moves down the organizational structure. In addition, oversight groups, such as a senior management council, may recommend to the agency head which deficiencies are deemed to be material to the agency as a whole, or which conditions are reportable, and therefore should be included in the annual Federal Managers' Financial Integrity Act report to the President.⁸

⁸See footnote 5 regarding senior management councils as discussed in OMB Circular A-123. In addition, see the standard for reporting to external parties.

EVALUATION AND REPORTING STANDARDS

The second group of internal control standards consists of three standards which address the evaluation of the effectiveness of the agency internal control, reporting on internal control to parties external to the agency, and responding to audit findings and recommendations. These standards are discussed below.

Effectiveness of Internal Control

For internal control to be judged effective, management must have reasonable assurance that

- **the agency's operational objectives are being met,**
- **the published financial statements and reports prepared for internal and external use (such as budget execution reports) are reliably prepared, and**
- **compliance with applicable laws and regulations is being achieved.**

Internal control is a process, but the effectiveness of the control is the state or condition of the process at a specific time. Since internal control is designed to help an entity achieve its objectives, the measurement of effectiveness should be closely tied to how well internal control is judged to be helping management meet those objectives. A subset of objectives for internal control relates to safeguarding of assets. Therefore, a measurement of the effectiveness of an agency's internal control with regard to safeguarding of assets would be as follows:

Internal control can be judged effective in safeguarding assets if management has reasonable assurance that unauthorized acquisition, use, or disposition of the agency's assets is being prevented or detected promptly.

Determining whether an agency's internal control is effective should be based upon an assessment of whether the five component standards have been met.⁹ The component standards are those that relate directly to the functioning and operation of internal control. They address the control environment, risk assessment, control activities, information and communication, and monitoring of control. The effective functioning of

⁹Only the five component standards are used in evaluating the internal control process. While the standards on reporting to external parties and resolution of audit findings are critical to understanding the condition of internal control and to making corrections or improvements to it, they are not part of the normal, daily activities essential to effective operations.

these component standards provides management with reasonable assurance regarding the achievement of objectives in one or more of the stated categories or subsets of those categories. Therefore, these component standards are the criteria against which internal control effectiveness is measured.

All five component standards must be met for internal control to be effective. This does not mean, however, that each standard should be met in an identical manner, or even at the same level, in different agencies. All the standards have to be considered in the context of the particular agency and its own set of conditions and circumstances. Some trade-offs may exist between standards. A specific internal control can serve a variety of purposes. A control designed to meet the requirements of one standard might also serve the purposes of a control that might ordinarily be present to meet the requirements of a different standard. In addition, a control can differ in the degree to which it addresses a particular risk so that a complementary control, with limited effect, together can satisfactorily meet the requirement.

The significance of internal control weaknesses must be evaluated in determining their impact on the five component standards and the control objectives. OMB has provided guidance on materiality for reporting matters under the FMFIA in Circulars A-123 and A-127, "Financial Management Systems," July 23, 1993. OMB defines a deficiency in internal control as a material weakness when the agency head determines the weakness to be significant enough to be reported in the required external FMFIA report. Additional guidance for evaluating financial reporting deficiencies is provided by Generally Accepted Auditing Standards (GAAS) issued by the American Institute of Certified Public Accountants. GAAS defines a material weakness as a reportable condition¹⁰ in which the design or operation of internal control does not reduce to a relatively low risk that losses, noncompliance, or misstatements in amounts that would be material in relationship to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. The existence of a material weakness is prima facie evidence that one or more internal control objectives are not being met. Further, reportable conditions, in combination, may result in a material weakness.

Inspectors General reports along with other reports on agency operations and financial reporting, such as an audit report on the entity's financial statements, should be considered in evaluating whether the objectives of internal control are being met. All internal control deficiencies identified by managers and employees should be reported to higher level managers in the organization.

¹⁰GAAS defines a reportable condition as a matter which could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may adversely affect one or more of the five component standards of internal control.

Reporting to External Parties

Management shall provide an annual public report presenting its assertion about the effectiveness of its internal control.

The Federal Managers' Financial Integrity Act of 1982 requires annual reporting on agency internal control. The Act directs the head of each executive agency to provide an annual statement as to whether the agency's internal control complies with the standards prescribed by the Comptroller General. Essentially, this requires the report to make a declaration as to the effectiveness of the internal control. If the internal control does not comply with such requirements, the report is to identify material weaknesses and the plans and schedule for correcting those weaknesses. OMB Circular A-123 "Management Accountability and Control," provides agencies guidance on how to satisfy the FMFIA reporting requirement.

Prompt Resolution of Audit Findings

Audit findings shall be promptly resolved.

Managers are to (1) promptly evaluate findings and recommendations reported by auditors, (2) determine proper actions in response to audit findings and recommendations, and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.¹¹

This standard requires managers to take prompt, responsive action on all findings and recommendations made by internal or external auditors. Responsive action is action that corrects identified deficiencies or demonstrates that corrective action would not be necessary. When audit findings identify opportunities for improvement rather than cite deficiencies, responsive action is action that produces improvements.

The audit resolution process begins when the results of an audit are reported to management, and is completed only after action has been taken that (1) corrects identified deficiencies, (2) produces improvements, or (3) demonstrates the audit findings and recommendations are either invalid or do not warrant management action, in the case where management disagrees with the audit recommendations.

Management (as well as auditors) should follow up on audit findings and recommendations to ascertain that resolution has been achieved. Auditors' findings and recommendations should be monitored through the resolution and follow-up processes.

¹¹This standard is required by the Federal Managers' Financial Integrity Act of 1982, which states that "The standards prescribed by the Comptroller General under this paragraph shall include standards to ensure the prompt resolution of all audit findings."

Top management should be kept informed through periodic reports so it can ensure the quality and timeliness of individual resolution decisions.

INDIVIDUAL ROLES AND RESPONSIBILITIES

Everyone in an agency has some responsibility for internal control. Management, however, is responsible for internal control with the ultimate responsibility at the top with the agency head. Many others within the organization also carry some responsibility for internal control within their particular functional or activity areas. Many groups external to the agency contribute to the effectiveness of the internal control, but they are not usually considered to be a direct part of the structure.

Management

Agency management is directly responsible for all activities of the entity including internal control. Of course, management at different levels has different internal control responsibilities. The head of the agency has ultimate responsibility and his or her influence on internal control cannot be overstated. The senior managers at the activity level and in the functional areas should have responsibility for internal control related to their units' objectives and they should provide direction and guidance for effective internal control policies and procedures within their areas. Likewise, down the chain of command, lower-level managers and supervisors should take responsibility for more specific internal control activities and procedures.

Agency Chief Financial Officers (CFO) and other financial and accounting personnel are of particular significance in monitoring internal control since their activities cut across all of the entity. They are often involved in entitywide planning and budgeting and are in a unique position for detecting fraud. In addition, as a member of top management, the CFO helps set the tone of the organization with regard to ethical conduct and can highlight the importance that should be placed on reliable financial reporting and internal auditing.

Regarding internal control, one of the most important units is an audit committee. While duties and responsibilities of an audit committee may vary from entity to entity, certain characteristics and functions are common to all. The committee is in the position to question top management on internal control decisions and to ensure that corrective actions are taken. Also, the audit committee is in the best position to prevent or question top management from overriding internal control. In some cases, the audit committee includes members from outside the entity, thus further strengthening the monitoring activities over control by the committee. While federal agencies' usually do not have

audit committees, some agencies do have a senior management council¹² which can, in many respects, fulfill the role of a board for some agencies. In addition, it may be possible in the future for some agencies to have groups that fulfill the internal control functions and responsibilities of an audit committee.

Employees

All agency employees play some role in developing, maintaining, and assuring good internal control. In addition, all employees are responsible for communicating information about problems such as noncompliance with rules or violations of policy, etc., to higher levels in the entity. To ensure that all employees are involved in internal control, the roles and responsibilities of each person should be well defined and effectively communicated by management.

Inspectors General

Inspectors General directly assess internal control and make recommendations to management for improvements. All activities of the agency are potentially within the scope of their review, including operations, financial reporting, and compliance aspects of control. Inspectors General should be independent and have authority to report directly to the agency head to order appropriate action. Inspectors General communicate audit findings, analytical information, and recommendations for use in helping to achieve the agency's objectives. They also alert management to deficiencies in internal control that come to their attention during their audits.

It is important to note that the Inspector General does not have the primary responsibility to establish or maintain internal control. That always belongs to the head of the agency.

External Auditors

Whether the agency is audited by government auditors or a private CPA firm, external auditors can provide a unique, independent, and objective view on internal control. External auditors usually have to gain sufficient knowledge of an agency's internal control in order to plan their audit. The amount of attention given varies from audit to audit. Nevertheless, auditors often are in a position to provide management with useful information about internal control, especially when deficiencies are found.

¹²See footnote 5 3-regarding Senior Management Councils as discussed in OMB Circular A-123.

The Congress

The mission and operations of a federal agency are governed by the legislative and oversight actions of the Congress. The agency's internal control is no exception. Laws enacted by the Congress require the development and implementation of internal control to help effectively and efficiently achieve the objectives of the program or other requirements of the legislation. A number of laws specifically address internal control including the Budget and Accounting Procedures Act of 1950, the Foreign Corrupt Practices Act of 1977, the Federal Managers' Financial Integrity Act of 1982, and the FDIC Improvement Act of 1991.¹³ The Congress, in its oversight of agency activities, may also enact additional legislation to improve agency operations that result in modified agency policies and procedures (internal control) needed to implement the requirements.

Other Oversight Bodies

Other oversight bodies include the central agencies (OMB, Treasury, GSA, and OPM) and GAO. The central agencies provide guidance to agencies. For example, GSA sets the requirements for certain areas including, federal property management and employees' travel, and the OPM has oversight over federal personnel matters. Treasury's responsibilities include providing financial policy and procedural guidance to agencies concerning financial reporting and other fiscal matters. OMB has broad responsibilities for central direction for budget formulation and oversight of agency operations, including information security. GAO supports the Congress in its role primarily through audits of agency operations and the spending of federal funds.

Other External Parties

External parties can supply insight to agency management that an internal control problem exists. This may come via complaints from those the agency serves including the public or specific customers, from vendors and suppliers with which the agency deals, or direct reporting of improprieties by employees. In addition, groups such as financial analysts, taxpayer groups, the news media, etc., are always interested in how well an agency is doing or not doing, its plans and objectives, and actions taken in response to political and economic activities. Their investigative and monitoring activities can provide management with information on how others perceive the agency's performance, the risks it faces, and the value of its strategies and actions. This information can be useful in enhancing internal control to achieve objectives.

¹³See appendix III for a more extensive listing of laws, requirements, and policies affecting internal control.

INTERNAL CONTROL LIMITATIONS

One of the fundamental concepts underlying the definition of internal control is that, no matter how well designed and operated, an agency's internal control structure can give only reasonable assurance, not absolute assurance, that objectives of the agency will be achieved. This is true because of limitations that are inherent in all internal control structures. These limitations include poor judgment and human mistakes, management's ability to override control, collusion by two or more persons to circumvent control, and the need to consider costs and benefits relative to internal control. In addition, no matter how well internal control operates, some events or conditions that can affect the achievement of objectives will always remain outside the control of management.

Judgment and Mistakes

The effectiveness of internal control may be limited by the realities of human judgments and mistakes. Decisions requiring judgment must often be made in a limited time without benefit of full information and under the pressures of conducting agency business. These judgmental decisions are likely to affect the achievement of objectives with or without good internal control. In addition, internal control can be rendered ineffective by ordinary personnel mistakes. This can happen, for example, by personnel misunderstanding instructions or making errors due to carelessness, distraction, or fatigue. Another example might be mistakes made by a temporary employee filling in for a regular employee on vacation or sick leave. These types of errors may occur because management has not provided proper supervision, training, or guidance. Internal control can not provide absolute assurance of protecting the agency from inefficient, inadequate, or inept managerial decisions.

Management Override

Management, by virtue of its authority, may be capable of overruling prescribed policies, procedures, or other control for improper purposes with the intent of personal gain or an enhanced presentation of the agency's financial situation or compliance status. Override practices could include deliberate falsifications or misrepresentations to agency officials, central agencies, lawyers, accountants, auditors, vendors, and others. It could also include issuing false documents, such as purchase orders or receipts. Management override, however, should not be confused with management intervention, which is management's departure from prescribed policies or procedures for legitimate purposes. Intervention may be necessary to deal with unusual or nonrecurring situations.

Management actions to intervene in internal control should be documented and disclosed to appropriate personnel.

Collusion

Collusion can result in an internal control failure. Individuals acting collectively to perpetrate and conceal an action from detection may be able to alter financial data or other management information in a manner that cannot be identified by internal control.

Costs Versus Benefits

Each entity must consider the relative costs and benefits of establishing specific internal control. In deciding whether a particular control should be established, the risk of failure and the potential effect on the entity should be considered along with the costs of establishing and maintaining the control. Usually, it is easier to estimate the cost of establishing the control as opposed to the more subjective measurement of the benefits provided. Even so, measuring cost can be difficult, especially with regard to issues such as management's commitment to ethical values or the competence of personnel. In addition, the complexity of cost-benefit determinations is compounded by the interrelationship of control when it is "built in" to the business processes and when several internal control activities operate together to mitigate a particular risk. The challenge is to find the right balance. Excessive control is costly and counterproductive. Too little control presents undue risks. However, management is responsible for maintaining effective internal control and the burden of proof rests with management in determining costs versus benefits of internal control.

APPENDIX I

QUESTIONS FOR RESPONDENTS TO THE PROPOSED STANDARDS

Suggestions and comments on this exposure draft are welcome from the entire federal community, the accounting and auditing profession, and academic community as well as others interested in improving the development of federal internal control. Comments on any section of the document are encouraged. Specific questions and issues related to each section and standard are presented below. These questions are intended as an aid for respondents reviewing the draft. Reviewers are not required to comment on the questions. Neither are they precluded from commenting on topics not specifically listed. Responses will be most helpful if they include relevant information, rationale, and alternatives, rather than mere expressions of preference.

Introduction

1. The most important and fundamental concepts underlying internal control are presented in this section. These include the view of internal control as a process, run by people, aimed at achieving objectives in one or more overlapping categories, and providing reasonable assurance that those objectives are being met. Are these fundamental concepts complete or would you suggest others that should be discussed here? If so, please list them and explain your reasoning.

Control Environment

2. This standard discusses seven major factors that significantly affect providing a positive and supportive attitude toward the agency's internal control. Are these complete? If not, what additional factors should be added and why?

Risk Assessment

3. This standard calls for the identification of internal and external risks which the agency may face and provides examples of several possible techniques for identifying those risks. Should any additional ones be discussed? Should any be removed and, if so, why?
4. The standard describes that risk analysis includes estimating risk significance, frequency and likelihood of occurrence, as well as considering actions to be taken to manage the risk. Do you agree with this

presentation? Are there

other issues regarding risk identification, analysis, and management that should be discussed at the broad standard level?

Control Activities

5. This standard discusses 10 major types of control activities (control procedures, techniques, methods, mechanisms, etc.) and states that these are not meant to be all-inclusive. Are there additional ones that you believe should be included here? If so, what are they and why should they be included?
6. Realizing that a standard is broad, high-level guidance, are the discussion and requirements of this standard adequate with regard to control over information systems? If not, what additional information or requirements should be included?

Information and Communications

7. This standard discusses and explains control that should be in place for the agency to gather information and communicate it to those who need it, both within the agency and external to it. Should any additional specific control be included? If so, what control, and why?

Monitoring

8. The standard presents two forms of monitoring--ongoing evaluations and separate evaluations, and discusses the control activities involved in each. Do you agree with this presentation and are there any additional control activities that should be added to either type of monitoring?

Effectiveness of Internal Control

9. The standard presents criteria for measuring the effectiveness of an agency's internal control based upon whether, and to the degree that, the component standards have been met. Do you agree with these criteria? Are there other methods or criteria that should be used to measure internal control effectiveness? If so, please explain.

Reporting to External Parties

10. Some specific requirements for reporting on internal control come from legislation and are reiterated by the requirements of this proposed standard. One requirement calls for the report to be signed by the head of the agency (as required by law). Should another high level official, such as the agency's chief financial officer, also sign the report? What would you add to or delete from the proposed standard and why?

Prompt Resolution of Audit Findings

11. The requirement to include this standard comes from the Federal Managers' Financial Integrity Act of 1982. It has been included almost completely as it appears in the current standards. Do you think it needs to be changed in any way?

Individual Roles and Responsibilities

12. The exposure draft states that management is ultimately responsible for internal control. It discusses the role that management has to play and then discusses the roles played in internal control by various other groups, both internal and external to the agency. Do you know of any other groups that should be included in this discussion? If so, what exactly are their responsibilities regarding internal control?

Internal Control Limitations

13. This section discusses the inherent limitations of internal control and the fact that the internal control structure can never provide absolute assurance that objectives will be achieved. The discussion specifically focuses on certain limiting factors, i.e., human judgment and mistakes, management override, collusion, and the cost versus the benefits of internal control. Do you believe any additional inherent limitations should be presented? If so, what limitations and exactly how do they affect the internal control structure?

CROSSWALK FROM EXISTING STANDARDS TO PROPOSED STANDARDS

EXISTING STANDARDS¹⁴

PROPOSED REVISION

Introduction

Purpose of Internal Control Standards

This document contains the Comptroller General's internal control standards to be followed by executive agencies in establishing and maintaining internal control as required by FMFIA.

See Introduction, page 5, first paragraph, first sentence--similar wording.

Objectives of Internal Control

- Obligations and costs comply with applicable law.
- All assets are safeguarded against waste, loss, unauthorized use, and misappropriation.
- Revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained.

See Introduction, page 5, where Objectives lists three major categories of internal control objectives:

- operations - relating to efficient and effective use of resources,
- financial reports - relating to preparation of reliable financial statements, and
- compliance - relating to the agency's compliance with laws and regulations.

A subset of these objectives is the safeguarding of assets.

Requirements of Management

- Make an annual evaluation of their internal control using guidelines established by OMB.

See Introduction, page 7, Evaluation and Reporting Requirements--similar wording.

¹⁴"Standards For Internal Controls In the Federal Government," GAO, 1983, Title 2, Appendix III, GAO Policy and Procedures Manual for Guidance of Federal Agencies.

See Monitoring Standard, page 30, footnote 7 states that continual monitoring and periodic evaluations should provide the basis for the annual assessment.

- Provide annual reports to the President and Congress that state whether agency systems of internal control comply with the objectives of internal control and with the standards.

See Introduction, page 7, Evaluation and Reporting Requirements--provide annual reports to the President--similar wording. (Also, see footnote 3, page 11.) See Reporting to External Parties Standard, page 35.

- Where systems do not comply, agency reports must identify the weaknesses involved and describe the plans for correction.

See Introduction, page 7, Evaluation and Reporting Requirements--similar wording. See Reporting to External parties Standard, page 35.

Definition of Internal Control

The plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

See Introduction, page 5, Definition, which says that internal control is a process, effected by an agency's management and other personnel, designed to provide reasonable assurance that the objectives of the agency are being met in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with laws and regulations. The definition also covers the safeguarding of assets.

Other Introductory Material

- The ultimate responsibility for good internal control rests with management.

See Introduction, page 6, Fundamental Concepts, Internal Control is Effected By People--similar wording. Also, see Individual Roles and Responsibilities, page 37, which says the head of the agency is ultimately responsible for internal control.

- Internal control should not be looked upon as separate, specialized systems

See Introduction, page 6, Fundamental Concepts, Internal Control is a Process--similar wording.

within an agency. Rather, they should be recognized as an integral part of each system that management uses to regulate and guide its operations.

- The internal control standards define the minimum level of quality acceptable for internal control systems in operation and constitute the criteria against which systems are to be evaluated. These internal control standards apply to all operations and administrative functions but are not intended to limit or interfere with duly granted authority related to development of legislation, rulemaking, or other discretionary policy-making in an agency.

See Internal Control Standards, page 9; Introductory paragraph uses same wording. See Detailed Explanation of Standards, page 12; introductory paragraph uses same wording.

General Standards

Reasonable Assurance. Internal control systems are to provide reasonable assurance that the objectives of the systems will be accomplished.

See Introduction, page 5, Definition of internal control states that they are designed to provide reasonable assurance that objectives are being met. See Introduction, page 6, Fundamental Concepts--one of the main concepts is that internal control structures can provide only reasonable assurance, not absolute assurance that objectives are being met. See section on Internal Control Limitations page 40, where introductory paragraph discusses the reasonable assurance concept.

Supportive Attitude. Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal control at all times.

See the Control Environment Standard, pages 13-16. The entire standard relates to management and employees establishing a positive and supportive attitude toward internal control. The Standard discusses seven major factors significantly affecting the control environment.

Competent Personnel. Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal control.

See the Control Environment Standard, pages 13-14, Integrity and Ethical Values and Commitment to Competence. These are two of the major factors significantly affecting the control environment. Management has a primary role in demonstrating integrity and ethical conduct. Management should be committed to developing and maintaining a high level of competence among all employees. See the Control Environment Standard, page 15, Human Resource Policies and Practices, which states that this factor ties closely with the ones on commitment to competence and assignment of authority and responsibility. Also, see Monitoring Standard, page 29, Ongoing Monitoring Activities. Asking employees regularly to state explicitly whether they understand and comply with the code of conduct is listed as an ongoing monitoring activity which agencies should incorporate into their internal control structures.

Control Objectives. Internal Control objectives are to be identified or developed for each agency activity and are to be logical, applicable, and reasonably complete.

See Introduction, pages 5-6, Definition and Objectives. This section discusses the establishment of objectives and subsets of objectives for the entire agency. Objectives at these different levels should be linked to activities throughout the organization and should be internally consistent and complementary.

Control Techniques Internal Control techniques are to be effective and efficient in accomplishing their internal control objectives.

See Control Activities Standard, pages 19-24. This standard addresses control activities which are the policies, procedures, techniques, and mechanisms that ensure that management's directives are being carried out to meet the agency's objectives. It states that control activities must be effective and efficient to provide a high degree of assurance that internal control objectives are being achieved.

Specific Standards

Documentation. Internal control systems and all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination.

See Control Activities Standard, page 22. Documentation is listed as a type of control activity that should be common to all agencies. Standard calls for documentation of internal control and all transactions and significant events. See Control Activities Standard, page 23, Control Over Information Systems, General Control: A particular type of general control is Application System Development and Maintenance Control which includes documentation requirements. See Monitoring Standard, pages 30-31, Separate Evaluations which states that an evaluator may find undocumented internal control. If these prove to be effective, they should be documented.

Recording of Transactions and Events. Transactions and other significant events are to be promptly recorded and properly classified.

See Control Activities Standard, page 21, where Recording of Transactions and Events is listed as a type of control activity that should be common to all agencies. Similar wording is used.

Execution of Transaction and Events. Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority.

See Control Activities Standard, page 21, where Execution of Transactions and Events is listed as a type of control activity that should be common to all agencies. Similar wording is used.

Separation of Duties. Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions should be separated among individuals.

See Control Activities Standard, page 21, where Segregation of Duties is listed as a type of control activity that should be common to all agencies. Similar wording is used. Also, see Monitoring Standard, page 29, Ongoing Monitoring Activities where separation of duties and responsibilities is listed as an ongoing monitoring activity which agencies should incorporate into their internal control structures.

Supervision. Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved.

See Control Environment Standard, pages 14-15, Assignment of Authority and Responsibility, which states that implicit in the assignment of authority and responsibility is the requirement to provide qualified and continual supervision to keep employees aware of their duties and to know the extent of their accountability. See Control Environment Standard, page 15, Human Resource Policies and Practices, which calls for supervision, review, and approval of assigned work. Similar wording is used. Also, see Monitoring Standard, page 29, Ongoing Monitoring Activities where appropriate organizational structure and supervision are listed as ongoing monitoring activities which agencies should incorporate into their internal control structures.

Access to and Accountability for Resources. Access to resources and records is to be limited to authorized individuals, and accountability for the custody and use of resources is to be assigned and maintained. Periodic comparison shall be made of the resources with the recorded accountability to determine if the two agree. The frequency of the comparison shall be a function of the vulnerability of the asset.

See Control Activities Standard, page 21-22. Access Restrictions to and Accountability for Resources and Records is listed as a type of control activity that should be common to all agencies. Similar wording is used.

Audit Resolution Standard

Prompt Resolution of Audit Findings.

See Prompt Resolution of Audit Findings Standard, pages 35-36--similar wording.

Managers are to:

- promptly evaluate findings and recommendations reported by auditors,

- determine proper actions in response to audit findings and recommendations, and
- complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

APPENDIX III

LAWS, REQUIREMENTS, AND POLICIES AFFECTING INTERNAL CONTROL

LAW/GUIDANCE

EFFECT

***Budget and Accounting
Procedures Act of 1950***

Establishes that GAO audits be directed at determining the extent to which . . . adequate internal financial control over operations is exercised.

Requires the head of each executive agency to establish and maintain systems of accounting and internal control designed to provide, among other things, effective control over and accountability for all funds, property, and other assets.

States that GAO audits shall consider the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices of the respective agencies.

***Foreign Corrupt Practices
Act of 1977***

Requires the Securities and Exchange Commission registrants to devise and maintain a system of internal accounting control sufficient to provide reasonable assurances that (1) transactions are executed in accordance with management's general or specific authorization, (2) transactions are recorded as necessary . . . to maintain accountability for assets, (3) access to assets is permitted only in accordance with management's general or specific authorization, and (4) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

***Federal Managers'
Financial Integrity
Act of 1982***

Requires GAO to prescribe standards of internal accounting and administrative control and agencies to comply with them.

Internal control provides reasonable assurance that (1) obligations and costs comply with applicable law, (2) assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures are recorded and accounted for properly so that accounts and financial and statistical reports may be prepared and the accountability of assets may be maintained.

Requires that the internal control standards include standards to ensure the prompt

resolution of all audit findings.

Requires OMB to establish guidelines for agency evaluation of internal control to determine compliance with the internal control standards.

Requires agency heads to (1) annually evaluate their internal control using the OMB guidelines, and (2) annually report to the President and the Congress¹⁵ on whether the agency's internal control comply with the standards and objectives set forth in the act. If they do not fully comply, the report must identify the weaknesses and describe plans for correction. The report is to be signed by the head of the agency.

Single Audit Act of 1984¹⁶

Requires that audits of state or local governments receiving federal financial assistance over specified amounts shall determine and report whether the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations.

If the audit finds any material weakness in the internal control, the State or local government shall submit to appropriate federal officials a plan for corrections to eliminate such weakness or a statement describing the reasons that correction is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by GAO.

Chief Financial Officers Act of 1990

States that the purposes of the Act are to ensure improvement in agency systems of accounting, financial management, and internal control; to assure the issuance of reliable financial information; and to deter fraud, waste, and abuse of government resources.

Requires that agency CFOs develop and maintain integrated agency accounting and financial management systems, including financial reporting and internal control.

Requires agency CFOs to prepare and transmit an annual report to the agency head

¹⁵The Federal Reports Elimination and Sunset Act of 1995 eliminates, effective for 1999, the requirement to report to the Congress.

¹⁶The Single Audit Act Amendments of 1996 included a number of changes to facilitate more uniform audit performance and reporting measurements for all types of organizations, such as measuring the dollar threshold that triggers an audit and requiring minimum program coverage of federal assistance.

and the Director of the OMB which shall include . . . a summary of the reports on internal accounting and administrative control systems submitted to the President and the Congress under the amendments made by the Federal Managers' Financial Integrity Act of 1982.

Requires government corporations to submit an annual management report to the Congress which includes a statement on internal accounting and administrative control systems by the head of the management of the corporation, consistent with the requirements for agency statements on internal accounting and administrative control systems under the amendments made by the Federal Managers' Financial Integrity Act of 1982.

***Federal Deposit Insurance
Corporation Improvement
Act of 1991***

Requires that insured depository institutions with assets of \$150 million¹⁷ or more prepare an annual report containing a statement of management's responsibilities for establishing and maintaining an adequate internal control structure. The report must also contain an assessment of the effectiveness of the internal control structure and procedures.

Requires that, with respect to such internal control reports, the institution's independent public accountant shall attest to and report separately on the assertions made by management.

***Government Performance
and Results Act of 1993***

The Act requires that an agency's strategic plan contain six key components: (1) a comprehensive agency mission statement, (2) agencywide long-term goals and objectives for all major functions and operations, (3) approaches (or strategies) and the various resources needed to achieve the goals and objectives, (4) a relationship between the long-term goals and objectives and the annual performance goals, (5) an identification of key factors, external to the agency and beyond its control, that could significantly affect the achievement of the strategic goals, and (6) a description of how program evaluations were used to establish or revise strategic goals and a schedule for future program evaluations. Internal control plays a major role in assisting management in achieving the agencies mission and providing meaningful information in plans and reports.

***Federal Financial
Management Improvement
Act of 1996***

States that much effort has been devoted to strengthening federal internal accounting control in the past, and, while some progress has been made,

¹⁷The act provided the Federal Deposit Insurance Corporation (FDIC) with authority to raise the \$150 million threshold. FDIC set the reporting threshold for insured depository institutions for assets of \$500 million or more (12 CFR 363).

accounting standards have not been uniformly implemented.

Requires each agency to implement and maintain financial management systems that comply substantially with (1) system requirements, (2) applicable federal accounting standards, and (3) the Standard General Ledger. The system requirements are generally recognized as the requirements contained in JFMIP's Federal Financial Management System Requirements series documents. These internal control standards are consistent with the JFMIP systems requirements.

Requires that each agency's annual audit report state whether the agency's financial management systems comply with the requirements and, if they do not comply, then the report is to state all facts pertaining to the failure to comply. Requires the head of each agency to determine whether there is compliance based on the audit report and any other information and, if systems are not in compliance, the head of the agency shall establish a plan to bring the systems into compliance.

Requires GAO to report annually to the appropriate committees of the Congress concerning compliance with the requirements and whether the financial statements of the federal government have been prepared in accordance with applicable accounting standards, and whether applicable accounting standards for the federal government are adequate.

***OMB Circular A-123,
"Revised, Management
Accountability and
Control"***

Provides guidance to federal managers on improving the accountability and effectiveness of federal programs and operations by establishing, assessing, correcting, and reporting on management control (internal control). Essentially, this is the OMB guidance for executive agencies required by the Federal Managers' Financial Integrity Act of 1982.

***OMB Circular A-127,
"Financial Management
Systems"***

Prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems including internal control.

Policies and references pertaining to internal control in this circular amplify policies in Circular A-123 or highlight requirements unique to financial management systems.

It requires that financial management systems include a system of internal control

and requires that appropriate internal control be applied consistently to all system inputs, processing, and outputs.

***JFMIP Framework for
Federal Financial
Management Systems***

Describes the framework for establishing and maintaining federal financial management systems, and explains what is meant by a single, integrated agency financial management system. Internal control is an essential part of the integrated financial management system, and this document contains a chapter on internal control that is consistent with these internal control standards.

***Statement of Federal
Financial Accounting
Concepts No. 1, Objectives
of Federal Financial
Reporting***

As a concepts statement, this document provides general guidance to the Federal Accounting Standards Advisory Board as it deliberates on specific issues. It is also intended to help others to understand federal accounting and financial reports. This specific concepts statement discusses the objectives of federal financial reporting.

The fourth objective addresses systems and control. It states that federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative control are adequate to ensure that

- transactions are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with federal accounting standards;
- assets are properly safeguarded to deter fraud, waste, and abuse; and
- performance measurement information is adequately supported.

APPENDIX IV

MAJOR CONTRIBUTORS TO THIS EXPOSURE DRAFT

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